No. 01-397

IN THE

Supreme Court of the United States

SCHOLASTIC CORPORATION and
RAYMOND MARCHUK,

Petitioners,

v.

RICHARD TRUNCELLITO and
THE CITY OF PHILADELPHIA,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF IN OPPOSITION

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STATEMENT OF THE CASE

Petitioners/Defendants Scholastic Corporation and Raymond Marchuk ("Petitioners") seek Supreme Court review of a ruling by the United States Court of Appeals for the Second Circuit which concluded that the [Corrected] Second Consolidated Amended Class Action Complaint (the "Complaint") stated a cause of action under Sections 10(b) and 20(a) of the Securities Exchange Act, 15 U.S.C. §§ 78j(b) and 78t(a), as amended by the Private Securities Litigation Reform Act, 15 U.S.C. § 78u-4.

Scholastic Corporation ("Scholastic" or the "Company") is a publisher and distributor of children's books and educational products. L. 6 (¶ 13).[1] At the time in question, the Company's most popular product was the "Goosebumps" series of children's books by R.L. Stine, which represented about 15% of its gross revenue for the fiscal year ended May 31, 1996. L. 13 (¶ 28). Scholastic distributed books through various retailers and wholesalers. Its accounting policy permitted it to recognize revenue on shipment of a book, even though the distributor or wholesaler had the right of return. This was permissible under generally accepted accounting rules as long as there was an adequate reserve for returns. L. 13-14 (¶ 30). Information concerning Scholastic's sales and return rate was therefore closely watched by security analysts and investors. L. 15, 16, 29, 31 (¶¶ 34, 36, 56, 60).

To monitor distributor sales and returns, Scholastic established an extensive system to collect and analyze the appropriate information in a timely fashion. The form and frequency of this information for specified distributors

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1. Respondents' have lodged with the Court a copy of the Complaint. Citations thereto will be in the form of L. __ (¶ __), with "L." designating the page of the lodging and "¶" designating the paragraph of the Complaint. Although Petitioners ask this Court to scrutinize the adequacy of the Complaint, they have not included it in the materials they have submitted to this Court.

representing well over two-thirds of the Goosebumps trade market is set forth in ¶ 38 of the Complaint, L. 16-17. Scholastic also had its own internal monitoring system which routinely collected sales information on a weekly basis in reports to division heads and transmitted data on returns from its Jefferson City warehouse to headquarters on a daily basis. L. 17-18 (¶ 39). Directors received monthly reports. *Id.*[2]

Prior to the beginning of the Class Period,[3] Scholastic publicly touted to security analysts and investors that its return rate of approximately 15-20% was among the lowest in the industry. L. 15-16 (¶¶ 34, 36), that Goosebumps "continued to sell well in the trade," *id.* (¶ 35), and that "*the issue of managing return exposure [was] one that gets considerable management attention.*" L. 15 (¶ 34).[4]

Nevertheless, by September 1996, Plaintiffs allege that Scholastic had experienced a significant decrease in sales and increase in returns of Goosebumps books. L. 18-21 (¶¶ 41-47). The Complaint supports these allegations by citing September 1996 sales statistics for Scholastic distributors constituting well over two-thirds of its trade business which showed a sharp decline from the previous year.[5]

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2. Given the electronic data systems in place, Scholastic had the ability to collect and analyze sales and returns data on a more frequent basis as circumstances warranted.

3. The "Class Period," December 10, 1996 through February 20, 1997, is the period of time during which Plaintiffs allege that Defendants made materially false, misleading and omissive statements. L. 9 (¶ 18).

4. The market's reliance on Scholastic's internal monitoring of returns was heightened by the fact that Scholastic disclosed its accounting for returns only on an annual basis. No statistical or financial information on returns was included in Scholastic's quarterly reports. L. 13-14 (¶ 30).

5. According to the Complaint, sales to Ingram, which represented 50% of Scholastic's trade business, L. 17 (¶ 38c), had suffered a (Cont'd)

By December 10, 1996, the beginning of the Class Period, when Scholastic publicly reported its second quarter performance, declining sales and increasing returns of Goosebumps had reached such a level and had gone on for a sufficient period of time that it could no longer avoid disclosing these facts to the market without violating Federal securities laws.[6]

Specifically, Plaintiffs' Complaint alleged that several mid-December 1996 statements made by Petitioners were materially misleading and omitted material information because they were completely silent regarding the material decline in sales, the material increase in returns and the materially reduced outlook for licensing revenues.[7] Sales remained dramatically down from the previous year. L. 18-19 (¶¶ 41-43) (citing results from distributors representing over two-thirds of the Goosebumps

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(Cont'd)
"significant decrease." L. 18 (¶ 41). Advanced Marketing Services, which accounted for 15% of the trade market, had seen its Goosebumps sales drop from 80,000 books per week in June 1995 to 40,000 books per week in the fall of 1996. *Id.* Fifty percent declines in sales were also reported by Aramark and Caldor. L. 18-19 (¶ 42). Year to year comparisons are appropriate in light of the seasonal nature of Scholastic's business (relating to the school year).

6. In addition, by this time, Scholastic knew that it would not be earning "significant amounts of projected revenues" it anticipated from Goosebumps merchandise licensing fees. L. 32 (¶ 66).

7. The statements are identified with particularity in ¶¶ 48, 50 and 54 of the Complaint. L. 21-24, 26. Petitioners argue that the Complaint seeks to hold Scholastic "responsible for the analysts' statements." Pet. at 8. This is incorrect. Plaintiffs cite these analyst reports only for the statements in them which were attributed to Scholastic. Nowhere do Plaintiffs seek to hold Scholastic liable for the analysts' own views or opinions. Imposing liability on those who provide materially false information to the market through securities analysts is a well accepted principle. *See, e.g., Cooper v. Pickett*, 137 F.3d 616, 623-624 (9th Cir. 1997).

trade market). In addition, the increased returns, which the Company had sought to forestall by providing extended payment dates and other unusual incentives, L. 19 (¶ 44), had now hit the Company with considerable force. L. 20-21 (¶ 46). For example, returns through Levy Distributors reached "unprecedented levels" in November and December 1996. L. 20 (¶ 46(c)). Toys R Us returned an "unusually high amount" of Goosebumps books in December and advised the Company that this resulted from consumer complaints regarding the scary nature of the series. *Id.* (¶ 46(a)).[8]

At the same time, a dispute between Scholastic and Goosebumps author R.L. Stine over negotiations regarding the renewal of marketing rights for Goosebumps-related products came to a head. Revenue from these marketing activities was a "high margin" part of Scholastic's business and had increased 129% in the previous quarter. L. 31-32 (¶ 63). Scholastic counted on the continued receipt of these revenues and factored them into their assurances to the market regarding third quarter earnings. L. 32 (¶ 64). However, unknown to the market, things were not going well in the negotiations and during the late fall

8. Petitioners claim that the Complaint "did not allege any declining sales or rising returns during October to December, other than vaguely noting "unusually high" returns from one retailer in December. Petition ("Pet.") at 8. *See also* Pet. at 10 ("there were no specific allegations about any additional declines in sales during October to December"). This is incorrect both with regard to sales and returns. For example, the 50% drop in AMS weekly sales is alleged to have occurred by "the fall of 1996 (during the second quarter)." L. 18 (¶ 41). *See also* L. 18-19 (¶ 42) (Aramark sales dropped 50% "between September 1995 and the fall of 1996"). The fall, of course, includes the months of October and November and the first twenty-one days of December. Additionally, the point is not that there were *further* declines from September to December, although there were, but that when the drop in sales had not picked up by December, Petitioners were therefore obligated to disclose that fact, *i.e.*, it had become a trend as opposed to a momentary drop. Petitioners' argument is symptomatic of their narrow reading of the Complaint and their insistence on not according *any* inferences in favor of Respondents.

of 1996, according to Scholastic's own pleadings in subsequent litigation, Stine's company, Parachute Press, engaged in a "campaign of obstruction and harassment" which "significantly disrupted" Scholastic's ability to earn Goosebumps licensing revenue and caused the Company to lose "significant amounts of projected revenues." *Id.* (¶ 66).

All of these facts contrast dramatically with Petitioners' rosy picture of the second quarter results, third quarter expectations and their complete silence regarding increasing sales and returns, making the mid-December statements actionable under the securities laws.[9]

Scholastic next spoke publicly to the market in mid-January. L. 27 (¶ 55). The Complaint lays out additional detailed information which became available to Scholastic in this period. In the area of sales, Scholastic's largest distributor, Ingram, accounting for over 50% of its trade business, L. 17 (¶ 38c), had cut its order in half from 25,000 copies per title to 12,000 copies per title. L. 21 (¶ 47(b)). Caldor, whose year-to-year sales had already declined 50% by September 1996 to a level of 3,000 books per week, L. 18 (¶ 42), reduced its orders further to 1,800 books per week. L. 21 (¶ 47(a)).

In the area of returns, year-to-year comparisons showed an increase of 150% in the overall level of returns in January, amounting to $4 to $5 million for the month. *Id.* (¶ 46(e)).[10]

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9. Petitioners find fault with the Complaint for not alleging "what Scholastic knew *on December 10* that should have been disclosed." Pet. at 10. However, the Complaint does precisely that in ¶ 49. L. 22-23.

10. Petitioners claim that the Complaint admits "Scholastic did not learn about [January] returns until February." Pet. at 8. This is also incorrect. While information regarding returns for the *entire* month of January was not compiled until early February, L. 30 (¶ 58), Petitioners admitted to the close monitoring of returns and the Complaint (Cont'd)

Distributor Levy returned between 50% and 70% of its October and November "purchases" in January. L. 20 (¶ 46(c)).[11]

Incredibly, even at the end of the month, Petitioners continued to deceive the market. In late January, the Merrill Lynch analyst responsible for following Scholastic spoke with Scholastic management to obtain an update on the Company and subsequently published a report on January 31, 1997 stating that the Company "suggest[ed] that there has *not* been a surge in book returns." Viewing this an "important" development, Merrill upgraded its rating on Scholastic from "neutral" to "accumulate." L. 29 (¶ 56) (emphasis added). Based on this positive report, Scholastic's stock jumped by $1.50 a share to $58.75. *Id.*

As the end of the quarter drew closer, Merrill continued to inquire of the Company regarding book return rates and the Company gladly continued to provide misinformation. In early February, *after* the returns data for the full month of January had become available showing a 150% increase over the previous January, L. 30 (¶ 58), the Company told Merrill that returns remained at "normal" levels. L. 31 (¶ 60).

Finally, with only one week left in the third quarter, Scholastic began to tell the truth on February 20, 1997. In a press release, Scholastic now told the market that it anticipated

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(Cont'd)

particularizes several sources of sales and return information that were updated on a weekly or daily basis. L. 16-18 (¶¶ 38-39). Petitioners also fault the Complaint for not specifying "the size of the decline [in sales] or giv[ing] any date on which Scholastic actually knew about those declines." Pet. at 10. Due to the dramatic deterioration of sales and returns in January and given the detailed daily and weekly sales and return data available to the Company, L. 17-18 (¶ 39), the overall January results could not have come as a shock to Petitioners.

11. *See also* L. 20-21 (¶¶ 46(b),(d)).

a *loss* of $ .70 to $ .80 per share for the quarter. L. 32-33 (¶ 68).[12] Updating its previous repeated statements that returns were well managed and at "normal" levels, L. 15, 29, 31 (¶¶ 34, 56, 60), Scholastic announced that it would take a special pre-tax charge of $13 million, consisting primarily of a reserve for additional book returns. L. 32-33 (¶ 68). Scholastic later revealed that its trade sales had declined 20% in the quarter. L. 34 (¶ 75(b)).

Given the sharp divergence of the February 20, 1997 announcement from Scholastic's previous public comments, market investors and analysts reacted in shock and dismay. Scholastic's stock sunk to a four-year low before closing at $36.75 per share on February 21, 1997, a one-day drop of $24.75, or 40% of its previous market value. L. 33 (¶ 69). Analysts that followed the stock called the Company a liar in print, *id.* (¶ 70) ("management's credibility has been shaken"); L. 34 (¶ 72) ("the timely dissemination of information remains an unrecognized problem and as such will likely persist"); *id.* (¶ 73) ("Management credibility has been damaged. The question is raised: 'what did you know and when did you know it and why'd you take so long to tell me?' ").[13]

THE DECISION BELOW

The Second Circuit, reversing the decision of the United States District Court for the Southern District of New York, held that the Complaint properly stated and pled a cause of

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12. *Cf.* L. 23-24 (¶ 50) (Company endorses earnings of $ .64 for the third quarter). The actual reported result was a loss of $ .78 per share for the quarter. L. 35 (¶ 75(d)).

13. Declining sales and increasing returns continued, as fourth quarter losses almost equaled those of the third quarter. L. 35 (Cplt. ¶ 77). Yet another special charge was taken at the end of the fourth quarter, this time in the amount of $11 million. *Id.* (Cplt. ¶ 78). Scholastic attributed fourth quarter results to "lower trade sales and higher returns (particularly related to Goosebumps)." *Id.* (Cplt. ¶ 77).

action. The Court correctly stated that, pursuant to the requirements of Section (b)(1) of the PSLRA, Plaintiffs' Complaint "shall specify each statement alleged to have been misleading, [and] the reason or reasons why the statement is misleading." Further, according to the Second Circuit, the Complaint must be stated with particularity and "identify the statements plaintiff asserts where fraudulent and why, in plaintiff's view, they were fraudulent, specifying who made them, and where and when they were made." Pet. App. 8a-9a.

The Second Circuit found that the Complaint set forth "sufficiently detailed" allegations that Defendants "knew, despite the fact that their business was cyclical, of a material downward secular trend." Pet. App. 18a. *See also* Pet. App. 17a ("with the second and third quarters covering months when revenues should have increased, plaintiffs have alleged enough to permit proofs that Scholastic should have been alerted, by decreased sales and increased returns, to negative business results in the relevant time frame"). The Court properly accepted the particularized allegations in the Complaint as establishing Defendants' knowledge or reckless disregard for the decreasing sales and increasing returns experienced by Scholastic.

> The complaint specifically sets out the distributors through which Goosebumps books were sold, and alleges declines in sales as of specific dates, some in terms of percentage and other in terms of quantity. Such information covers over two-thirds of Scholastic's trade business in Goosebumps.

Pet. App. 11a. Importantly, the Court recognized that, according to the Complaint, Defendants not only had access to point-of-sale data, "but also reviewed it." *Id.*

Similarly, the Second Circuit found allegations concerning ballooning returns sufficiently particular and in accordance with the PSLRA's heightened pleading standards. Pet. App. 13a-14a.

The Second Circuit criticized the District Court for failing "to take into account the alleged facts that Scholastic reviewed POS data made available by AMS and Caldor on a daily basis, by Target on a weekly basis and by Ingram to learn returns would be on the rise." Pet. App. 15a. Moreover, the Second Circuit applied the proper standard in evaluating Plaintiffs' allegations as to Company-generated internal reports. In this regard, the Second Circuit held that "a plaintiff needs to specify the internal reports, who prepared them and when, how firm the numbers were or which company officers reviewed them." Pet. App. 15a. The Second Circuit specifically found that Plaintiffs met this heightened standard:

> Plaintiffs have satisfied this standard by specifying who prepared internal company reports, how frequently the reports were prepared and who reviewed them. We further observe that the complaint gives additional indications as to the nature of the reports, because the allegations are immediately preceded and followed by figures from retailers to show sales were declining.

Pet. App. 16a.

The Second Circuit found as additional support Plaintiffs' allegations concerning the Company's engagement in aggressive sales practices during the Class Period in order to delay disclosure of the huge amount of book returns and delay having to set up an adequate reserve as well as the $13 million pre-tax special charge taken by the Company in February 1997 for anticipated book returns. *See, e.g.*, Pet. App. 16a (aggressive sales practices "would furnish additional support for the proposition that company officials were aware of declining sales and increasing returns"); Pet. App. 17a (the $13 million pre-tax special charge "lends yet more support to the notion that defendants had knowledge of increasing returns").

With respect to scienter, the Second Circuit reiterated its well-established rule that a complaint could survive scrutiny by (a) pleading facts demonstrating that defendants had both the motive and an opportunity to commit fraud or (b) otherwise alleging facts to show strong circumstantial evidence of defendants' conscious misbehavior or recklessness. Pet. App. 19a. With regard to Petitioner Marchuk, the Second Circuit focused principally on Plaintiffs' insider trading allegations, adhering to the Circuit's long-held view that " 'unusual' insider sales at the time of the alleged withholding of negative corporate news may permit an inference of bad faith and scienter." Pet. App. 20a. Applying this standard, the Second Circuit found that Plaintiffs' insider trading allegations, along with other facts in the Complaint, were sufficient to establish scienter as to Defendant Marchuk. Pet. App. 20a-21a.[14]

As to Petitioner Scholastic, the Second Circuit found that the Complaint sufficiently pled allegations concerning Defendants' knowing or reckless conduct. Specifically, the Second Circuit held that:

> the second amended complaint contains detailed allegations as to what defendants knew on a daily, weekly and monthly basis about the retail trade of Goosebumps books, while at the same time making public statements that painted a different picture. Defendants publicly represented that returns were not increasing and failed to adjust revenues despite

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14. The Second Circuit also accepted as additional allegations of Defendant Marchuk's motive; namely, the fact that he was primarily responsible for Scholastic's communications with investors and industry analysts, was involved in the drafting and/or disseminating false and misleading statements during the Class Period, had access to internal corporate documents and reports relating to trade sales and return data, attended management and committee meetings and prepared the Directors' Books. Pet. App. 22a.

> their knowledge of rapidly rising returns; these actions, if proven, are consistent with recklessness.

Pet. App. 24a. As evidence of Defendants' scienter, the Second Circuit found particularly compelling allegations in the Complaint concerning Scholastic's response to inquiries from Merrill Lynch in early February 1997.

> At this point, even disregarding the information ostensibly reviewed from computer runs, Scholastic knew the return rate for January 1997 had increased 150 percent from the year before. Yet by telling Merrill Lynch that return rates remained at normal levels of 20 percent, defendants acted in ways that could be found to be reckless.

Pet. App. 24a.

REASONS FOR DENYING THE WRIT

I. CERTIORARI SHOULD BE DENIED BECAUSE THE SECOND CIRCUIT'S APPLICATION OF THE STANDARDS FOR PLEADING THE CIRCUMSTANCES OF THE FRAUD WAS CONSISTENT WITH THE PSLRA AND WITH RULINGS IN OTHER CIRCUIT COURTS OF APPEALS

A grant of Certiorari would be inappropriate in this case because the detailed allegations in the Complaint satisfy the statutory requirements for pleading the circumstances of the fraud articulated in the PSLRA. The Second Circuit's application of that standard here was consistent with rulings of other circuits which have addressed this issue. This case, therefore, is not an appropriate vehicle to resolve any purported differences in pleading standards. In addition, this case is a poor candidate for review because Petitioners never raised the issue of the proper pleading standard in any of their arguments below, or, for that matter, even challenged the application of the Second Circuit's

pleading standard (as they seek to do here).[15] Thus, if the Court were to accept this issue, it would be reviewing general statements about the law that were never applied to the pleading at issue in this case.

A. The Particularized and Detailed Facts Pled in the Complaint Regarding Sales and Returns of Books Satisfy the Statutory Requirements for Specificity in Pleading the Facts Constituting Fraud

In this case, the Second Circuit found that the Complaint satisfied the heightened pleading standards under Sections 21D(b)(1) and (2) of the PSLRA.

The Court based its decision on the well-pled and particularized allegations in the Complaint which cited reports of declining sales or increasing returns of Goosebumps from fifteen different distributors and retailers starting in September 1996 and continuing throughout the Class Period. L. 16-21 (¶¶ 38-47). Additionally, the Complaint alleges that Scholastic internally monitored trade sales and returns of Goosebumps. These allegations are not merely boilerplate assertions of internal controls. Indeed, the Complaint is so particularized that it identifies the Scholastic employee responsible for compiling one such report (Leslie Lista), the title of the report ("Director's Book"), the recipients (Scholastic's Board of Directors), and the frequency of the report (monthly). L. 17-18 (¶ 39). Based on these and other allegations, the Second Circuit concluded, the Complaint "contains detailed allegations as to what Petitioners knew on a daily, weekly and monthly basis about the retail trade of Goosebumps books, while at the same time making public statements that painted a different picture."

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15. *EEOC v. Fed. Labor Relations Auth.*, 476 U.S. 19, 24 (1986) ("Our usual practice, from which we see no reason to depart on this occasion, is to refrain from addressing issues not presented in the Court of Appeals").

Pet. App. 24a. This is precisely what is required under (b)(1) of the PSLRA.

Petitioners' precise dissatisfaction with the Second Circuit opinion is not readily apparent. However, Petitioners do raise three specific areas where, they argue, the Second Circuit differs from other courts of appeals: the purported endorsement of "fraud by hindsight," Pet. at 17-18; the purported rejection of the statutory requirement to plead "all" facts, Pet. at 18-19; and the purported rejection of the statutory requirement that scienter allegations result in a "strong inference" of knowing misconduct. Pet. at 20-21. In each instance, Petitioners misread the opinion below and grossly exaggerate any differences which may exist in the language used by the appellate courts.

1. Fraud by Hindsight.

Petitioners argue that the Second Circuit inappropriately allowed Plaintiffs to plead fraud by hindsight — the use of subsequent disclosures to conclude that earlier statements were false. Pet. at 11. Petitioners are correct that the practice of pleading fraud by hindsight has been unacceptable, even before the PSLRA. Indeed, it was the Second Circuit that advanced this position over two decades ago in *Denny v. Barber*, 576 F.2d 465, 470 (2d Cir. 1978), and has reaffirmed it in numerous decisions, including most recently in *Novak v. Kasaks*, 216 F.3d 300, 309 (2d Cir. 2000), *cert. denied*, __ U.S. __, 121 S. Ct. 567 (2000) ("we have refused to allow plaintiffs to proceed with allegations of 'fraud by hindsight' "). This principle, moreover, is consistent with the law in other circuits. *See, e.g., Silicon Graphics*, 183 F.3d at 988.

To contend, as Petitioners do here, that the Second Circuit violated this well-established precept and *sub silentio* overruled twenty-five years of precedents is patently absurd. Petitioners construct this argument from the court's acknowledgement that Scholastic's post-class period announcement of a special charge for book returns supported the inference of fraud established

by other allegations in the Complaint. The Second Circuit did not base its holding that fraud was sufficiently pled solely on Petitioners' subsequent announcements. Rather, as the Court explained (and Petitioners choose to ignore), Scholastic's post-class period announcement represented *additional* evidence establishing Petitioners' state of mind. Pet. App. 17a (the charge "lends yet more support"). The Second Circuit did not consider this post Class Period event in a vacuum. The consideration of this type of allegation as additional evidence of fraud is consistent with the Second Circuit's prior holdings (which Petitioners never challenged below on this point)[16] as well as precedent in other circuits, including the Ninth Circuit.

Indeed, an analysis of case law from other circuits demonstrates a consistency in the recognition that post-class period disclosures which are inconsistent with recently made statements during the class period may tend to show that the latter were misleading. This jurisprudence is particularly well developed in the Ninth Circuit. *Fecht v. Price Co.*, 70 F.3d 1078, 1083-84 (9th Cir. 1995), *cert. denied*, 517 U.S. 1136 (1996) ("shortness of time [between negative post-class period disclosure and optimistic class period statements] is circumstantial evidence that the optimistic statements were false when made"); *Cooper v. Pickett*, 137 F.3d 616, 627 (9th Cir. 1997) (short time period between post-class period disclosure of negative information and positive class period statements suggests "fraud, rather than business mistake viewed with the benefit of hindsight"); *Ronconi v. Larkin*, 253 F.3d 423, 437 (9th Cir. 2001) ("We have allowed the temporal proximity of an allegedly fraudulent statement or imission and a later disclosure to *bolster* a complaint, but we have never allowed the temporal proximity between the two, *without more*, to satisfy the requirements of Rule 9(b). . . . We hold the same in the context of the PSLRA") (emph. in original; citations omitted); *see also Shaw v. Digital Equipment Corp.*, 82 F.3d 1194, 1225 (1st Cir. 1996).

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16. *See, e.g., Rothman v. Gregor*, 220 F.3d 81, 92 (2d Cir. 2000); *Novak v. Kasaks*, 216 F.3d at 312-13.

2. The Purported Rejection of the "All Facts" Requirement.

The powerful facts alleged in the Complaint and found to be sufficient by the Second Circuit would, without question, satisfy any circuit court's articulation of the PSLRA pleading standard. Petitioners argue that the Second Circuit applied a more lenient pleading standard than three other circuits because it did not require Plaintiffs to plead "all facts" supporting their allegations. Pet. 18. Instead, the Second Circuit held that Plaintiffs "are required only to plead with particularity sufficient facts to justify those beliefs." *Id.*

The supposedly varying standards between the Circuits are, at best, nothing more than different judges using different words to say the same thing. This is demonstrated by examining the opinion below as a whole, and in the context of Second Circuit jurisprudence, rather than the single out-of-context sentence quoted by Petitioners. Thus, the Second Circuit noted that while a complaint need not include "detailed evidentiary material," it cannot simply rely on an "unsupported general claim of the existence of confidential company sales reports . . . to survive a motion to dismiss." Pet. App. 15a. Rather, the court then went on to state,

> a plaintiff needs to specify the internal reports, who prepared them and when, how firm the numbers were of which company officers reviewed them. Plaintiffs have satisfied this standard by specifying who prepared internal company reports, how frequently the reports were prepared and who reviewed them. We further observe that the complaint gives additional indications as to the nature of the reports, because the allegations are immediately preceded and followed by figures from retailers to show sales were declining.

Pet. App. 15a-16a. The Second Circuit specifically held that the Complaint here met applicable pleading standards, citing

First and Seventh Circuit opinions. *Id.* Indeed, the above-quoted language is completely consistent with the analysis in *Silicon Graphics*, 183 F.3d at 985 ("We would expect that a proper complaint which purports to rely on the existence of internal reports would contain at least some specifics from those reports as well as such facts as may indicate their reliability").

The practical application of the pleading standards are indistinguishable between the various courts. In *Silicon Graphics*, plaintiffs alleged in conclusory fashion that defendants' knowledge of the fraud was demonstrated by internal reports that contradicted the positive statements made to the public. The Ninth Circuit found, however, that the plaintiff "does not plead facts to corroborate her allegations." 183 F.3d at 985. Instead, the plaintiff relied solely on a boilerplate statement about what would be revealed by discovery. *Id.* (quoting complaint). This, according to the Ninth Circuit was "too generic." *Id.*[17]

Contrary to Petitioners' argument, the Ninth Circuit did not require the inclusion of literally all facts in the complaint. Rather, the court deemed sufficient the pleading of "relevant facts" with "some specifics" to establish the reliability of the allegations. *Id.* This is consistent with the Second Circuit's approach here.

Unlike the Complaint *Silicon Graphics*, the allegations in this case (as the Second Circuit correctly recognized) are

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17. *Greebel v. FTP Software, Inc.*, 194 F.3d 185 (1st Cir. 1999), and *Helwig v. Vencor, Inc.*, 251 F.3d 540 (6th Cir. 2001), are similarly inapposite. In *Helwig*, the Sixth Circuit did not address the application of the "information and belief" pleading requirements of the PSLRA other than to quote the statute. 251 F.3d at 550. In *Greebel*, the First Circuit did nothing more than reaffirm its prior decisions under Fed. R. Civ. P. 9(b), which did not require the pleading of every piece of evidentiary material supporting fraud allegations. 194 F.3d at 194.

not based on "generic," conclusory allegations that could be asserted against any corporation whose stock price has declined. Far from a "cookie-cutter" complaint with allegations that have been recycled from case to case, as in *Silicon Graphics*, the Complaint here is painstakingly detailed and is based on a variety of reliable sources quoted or referred to in the Complaint. The Complaint is replete with detailed factual allegations concerning the types of internal reports available and corroborating information from fifteen different distributors about the contents of those reports. Such allegations would pass muster under any standard, including that set forth in *Silicon Graphics*.

3. The Purported Rejection of the "Strong Inference" Standard.

Petitioners suggest that the Second Circuit flouted the PSLRA's requirement that inferences of scienter be "strong," and instead applied a standard that such inferences need only be "reasonable" (or "not unreasonable"), thus creating a conflict among the circuits (as well as with the statute itself). Pet. at 20-22. Petitioners' position is wrong in all relevant respects.

Petitioners' contention that the decision below adopts a "reasonableness" standard for judging inferences of scienter is contrary to the language of the decision itself. The decision clearly uses "reasonableness" language only when discussing inferences involving elements of fraud (such as falsity and materiality) other than scienter. When the decision discusses the scienter element, "strong inference" language as used.[18] The decision below thus conforms precisely to the PSLRA's requirements and to decisions from other circuits on this point.

Petitioners argue that the "Second Circuit accepted any inferences [of scienter] as long as they were 'not unreasonable,' "

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18. The PSLRA's mandate of pleading facts establishing a "strong inference" is limited to allegations of scienter. 15 U.S.C. § 78u-4(b)(2). As to other elements of fraud, the necessary inference may therefore be reasonable.

and specifically that the Second Circuit adopted the traditional Rule 12(b)(6) principle (that the court must "accept[ ] all of the allegations in the complaint as true and draw[ ] all reasonable inferences in favor of plaintiffs . . . .") in assessing the pleading sufficiency of scienter allegations. Pet. at 9.[19] This argument, however, completely misrepresents the decision below.

The Second Circuit acknowledged inferences which were "not unreasonable" only in referring to the post class period announcement of a special charge taken against earnings for an addition to Scholastic's reserves for returned books. The Court noted that is was "not unreasonable" to infer from this charge that Goosebumps trade business was in decline throughout the third quarter. Pet. App. 17a. As this inference was only considered to be supportive (but not determinative) of plaintiffs' allegation that there was a trend of growing returns, according to the PSLRA itself, this allegation is *not even subject to* the "strong inference of scienter" standard.[20]

Petitioners' description of the supposedly varying standards among the circuits create a false dichotomy. According to Petitioners, only the Second Circuit is out of step, due to its supposed application of general Rule 12(b)(6) standards for inferences of scienter. But as set forth above, Petitioners have simply conjured up a pejorative assertion about Second Circuit law on the strength of scienter inferences that is simply untrue and is not related in any way

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19. While the Second Circuit indeed references the traditional Rule 12(b)(6) standard, it appears at the very beginning of the opinion. Pet. App. 8a. When the Court turns to a discussion of scienter, it states clearly that it is governed by the more narrow requirements of the PSLRA. Pet. App. 18a-19a.

20. Even if deemed to support scienter which is discussed in an entirely separate section of the opinion, it is one of many circumstances cited by the Second Circuit which cumulatively reach the "strong inference" benchmark.

to its decision *in this case*. There is no division among circuits on this point, and no issue worthy of a grant of certiorari.[21]

4. Petitioners Failure to Raise any Challenge to the Second Circuit Standard in any of the Proceedings Below Weighs Against Granting Certiorari Because These Issues Have not Been Fully Developed by the Parties or Addressed by the Lower Courts.

In this case, petitioners focus on abstract statements in the Court of Appeals' decision and its routine citation to prior Second Circuit precedent to which petitioner never objected below. Petitioners failed to question, let alone to litigate, the matter of the appropriate pleading standard under the PSLRA in the Second Circuit. Accordingly, this case would be an

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21. Indeed, cases from all circuits continue to include recitations of the traditional Rule 12(b)(6) standards in their post-PSLRA decisions, because that standard does continue to apply other than with respect to inferences of scienter. *Howard v. Everex Sys.*, 228 F.3d 1057, 1060 (9th Cir. 2000) (citations omitted) ("treating the complaint's allegations as true and drawing all reasonable inferences in the plaintiff's favor"); *Nathenson v. Zonagen, Inc.*, 2001 U.S. App. LEXIS 20902 at *9-10 (5th Cir. Sept. 25, 2001) ("[W]e will accept the facts alleged in the complaint as true and construe the allegations in the light most favorable to the plaintiffs."); *City of Philadelphia v. Fleming Companies, Inc.*, 2001 U.S. App. LEXIS 19819 at *22 (10th Cir. Sept. 7, 2001) ("[A]ll well-pleaded factual allegations in the . . . complaint are accepted as true and viewed in the light most favorable to the nonmoving party."); *Theoharous v. Fong*, 256 F.3d 1219, 1224 (11th Cir. 2001) ("We . . . will uphold a dismissal only if it appears beyond doubt that the allegations in the complaint, when viewed in the light most favorable to the plaintiff, do not state a claim upon which relief can be granted."); *Helwig v. Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001) (*en banc*) ("we must construe the complaint in a light most favorable to the plaintiff, and accept all of [the] factual allegations as true. . . . Our willingness to draw inferences in favor of the plaintiff remains unchanged by the PSLRA.") (internal quotations and citation omitted); Thus, the Second Circuit's reiteration of this black letter law is nothing out of the ordinary.

extraordinarily poor vehicle to address the questions presented as these issues have not been meaningfully reviewed by a lower court.

As this Court recognized, "this Court reviews judgments, not opinions." *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842 (1984); *see also California v. Rooney*, 483 U.S. 307, 311 (1987) (per curiam) (dismissing writ as improvidently granted because "[t]his Court 'reviews judgments, not statements in opinions' ") (quoting *Black v. Cutter Laboratories*, 351 U.S. 292, 297 (1956)). "More particularly, [this Court] review[s] the judgment that the Court of Appeals entered in this case, not the judgment that it may have entered in some other case, or some isolated statement in its opinion commenting on the holding in some other case." *United States v. Doe*, 465 U.S. 605, 620 n.1 (1984) (Stevens, J., concurring in part and dissenting in part). Accordingly, this Court will not review "the *rationale* relied on by the Court of Appeals." *Texas v. Hopwood*, 518 U.S. 1088, 1088 (1996) (statement of Ginsburg, J., joined by Souter, J., respecting the denial of certiorari). "Any conflict in these two formulations [in the lower courts] is of no consequence here." *Johnson v. DeGrandy*, 512 U.S. 997, 1003 n.5 (1994).

II. CERTIORARI SHOULD NOT BE GRANTED TO REVIEW THE SECOND CIRCUIT'S RULING ON THE RELEVANCE OF INSIDER TRADING ALLEGATIONS TO THE PLEADING STANDARDS FOR SCIENTER SINCE THIS HOLDING RELATES ONLY TO DEFENDANT MARCHUK, THERE IS NO SIGNIFICANT CONFLICT AMONG THE CIRCUITS REGARDING THIS ISSUE AND OTHER ALLEGATIONS ALSO SUFFICE TO PLEAD SCIENTER

Certiorari is inappropriate to review the Second Circuit's reliance on insider trading allegations to conclude that the Complaint properly pled scienter. First, this analysis was used exclusively with regard to Petitioner Marchuk. Thus, any grant of certiorari on this issue would not impact the principal case against Scholastic. Second, all the Circuits to reach the issue of motive and opportunity pleading have concluded that insider trading allegations such as those asserted against Marchuk may give rise to a strong inference of scienter. The Complaint adequately pleads facts supporting a strong inference of Marchuk's actual knowledge or reckless disregard of material misstatements and omissions making the appropriateness of a motive and opportunity analysis moot.

A. The Circuit Court Only Considered "Motive and Opportunity" Allegations as to Defendant Marchuk

The Second Circuit's only reference to "motive and opportunity" as a means to plead scienter came in connection with Petitioner Marchuk and his insider trading during the Class Period. Pet. App. 19a-23a. In discussing the allegations against Petitioner Scholastic, the Second Circuit held, correctly, that the Complaint adequately alleged Scholastic's actual knowledge or reckless disregard that it was making false statements and omitting material information from its statements which would mislead investors. Pet. App. 23a-25a. Since the "motive and

opportunity" analysis relates only to one defendant, a grant of certiorari solely on this question would be inappropriate.

B. There is no Inter-Circuit Conflict Concerning Insider Trading Allegations

Contrary to Petitioners' argument, there is no conflict among the Circuits relating to the use of insider trading allegations of the type alleged here to adequately plead scienter. As the most recent Circuit Court to consider the issue observed,

> Putting aside the Ninth Circuit standard, which gives the deletion of the Spector amendment a more pointed reading than it will bear, *the split in the other Circuits is more apparent than real*. As we have discussed . . . , the Second Circuit has dramatically constricted the types of "motive and opportunity" that it will recognize as sufficient to plead scienter. It will not allow plaintiffs to proceed based on widely held motives such as "(1) the desire to maintain a high corporate credit rating or otherwise sustain 'the appearance of corporate profitability, or of the success of an investment, [or] (2) the desire to maintain a high stock price in order to increase executive compensation or prolong the benefits of holding office." *Novak*, 216 F.3d at 307 (internal citations omitted). Even complaints based on insider trading must allege more than that the defendant benefitted from trading because of a false statement or omission; the insider trades have to be "unusual," either in the amount of the profit made, the amount of stock traded, the portion of stockholdings sold, or the number of insiders involved, before they will give rise to the required inference of scienter. *See Rothman v. Gregor*, 220 F.3d 81, 94 (2d Cir. 2000); *In re Advanta*, 180 F.3d at 540-541; *Oran v. Stafford*, 226 F.3d 275, 290 (3d Cir. 2000). This is

> the same kind of inquiry undertaken by courts that do not adhere to the motive-and-opportunity formulation. *See Nathenson*, 2001 WL 1131511, at *16; *Helwig*, 251 F.3d at 552; *Greebel*, 194 F.3d at 198. *The search in the Second Circuit line of cases, as well as in the other circuits, is for facts that give a strong reason to believe that there was reckless or intentional wrongdoing. [citation omitted] Taken as a whole, the cases do not substantiate the fear that courts applying the motive-and-opportunity formulation will permit pleadings to go forward without facts strongly suggesting wrongdoing.*

Florida State Board of Administration v. Green Tree Financial Corporation et al., 2001 U.S. App. LEXIS 22921 at *37-*38 (8th Cir. October 25, 2001) (emphasis added). A close examination of the other Circuit decisions confirms that Petitioners' contention that there exists a substantive conflict among the Circuits is unfounded and that even the Ninth Circuit's decisions would support the sufficiency of the allegations against Marchuk.

Petitioners first point to *Greebel v. FTP Software, Inc.*, 194 F.3d 185 (1st Cir. 1999). After observing that "the words of the Act neither mandate nor prohibit the use of any particular method to establish an inference of scienter," *id.* at 195, the court went on to specifically reject the "argument that facts showing motive and opportunity can never be enough to permit the drawing of a strong inference of scienter," permitting "use of motive and opportunity type pleading if it raises a strong inference." *Id.* at 197. The First Circuit concluded that it was in agreement, not disagreement, with the Second Circuit as well as the Third and Fifth Circuits on this issue. *Id.* ("Three circuits have interpreted the PSLRA as permitting use of motive and opportunity type pleading if it raises a strong inference. *See In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534-35 (3d Cir. 1999); *Press v. Chemical Inv. Servs. Corp.*, 166 F.3d 529,

537-38 (2d Cir.1999); *Williams v. WMX Techs., Inc.*, 112 F.3d 175, 178 (5th Cir. 1997) (dicta)"). Moreover, the First Circuit went on to recognize that "[u]nusual trading or trading at suspicious times or in suspicious amounts by corporate insiders has long been recognized as probative of scienter." *Id.* at 197.

Similarly, in *Helwig v. Vencor, Inc.*, 251 F.3d 540 (6th Cir. 2001) (en banc), the Sixth Circuit observed that regardless of labels, "facts showing [motive and opportunity] may support a strong inference of recklessness" and therefore "may be of enough weight to state a claim under the PSLRA." *Id.* at 551. Agreeing with the First Circuit decision in *Greebel*, the Sixth Circuit emphasized that determining whether such allegations will suffice is a "fact-specific approach." *id.*, and that among the facts relevant to establishing a strong inference of scienter is "insider trading at a suspicious time or in an unusual amount." *Id.* at 552. *Accord City of Philadelphia v. Fleming Companies, Inc.*, 264 F.3d 1245, 1262 (10th Cir. 2001) ("We believe the most reasonable reading of the PSLRA in regard to motive and opportunity pleadings is the view adopted by the First Circuit in *Greebel* and the Sixth Circuit in *Helwig*."). Thus, there is no conflict among the Circuits.

Petitioners attempt to manufacture such a conflict by pointing to the Ninth Circuit's decision in *Silicon Graphics*, *supra*. There, however, after stating the unremarkable proposition that "plaintiffs proceeding under the PSLRA can no longer aver intent *in general terms* of mere 'motive and opportunity" or "recklessness," *id.* at 979 (emphasis added), which was the practice in the Ninth Circuit prior to enactment of the PSLRA, the court went on to specifically reaffirm its long held view that "unusual" or "suspicious" stock sales by corporate insiders could supply a basis for the requisite strong inference. *Id.* at 985-86. *Accord*, *Ronconi v. Larkin*, 253 F.3d at 434-35. Thus, *Silicon Graphics* presents no disagreement with the standard employed by the Second Circuit here.

Finally, Petitioners erroneously point to *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271 (11th Cir. 1999), as being in conflict with the Second Circuit. The *Bryant* court, however, in stating "that a showing of *mere* motive and opportunity is insufficient to plead scienter" was referring to generic motives not at issue here that any court would deem insufficient to plead scienter. The complaint at issue alleged such universal motives as the desire to maintain a high stock price or to reduce bank debt. *Id.* at 1274.[22] The *Bryant* court did not definitively resolve the impact of insider trading allegations, leaving that for the district court on remand. Thus, *Bryant* does not support a material divergence in the Circuit courts on the significance of insider trading allegations of the type alleged against Marchuk here. *See also In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 540 (3d Cir. 1999) ("if the stock sales were unusual in scope or timing, they may support an inference of scienter"); *Nathenson v. Zonagen, Inc.*, 2001 U.S. App. LEXIS 20902 at *52 (5th Cir. 2001) (unusual insider trading would have probative value in analyzing scienter allegations).

Thus, whether phrased in terms of motive and opportunity or direct evidence knowledge or recklessness, there is no disagreement among the circuits that unusual and suspicious insider trading is properly part of the total mix of facts that must be analyzed to determine whether scienter has been pled adequately and may suffice to support a strong inference of scienter.

In the instant case, the Complaint adequately pleads both unusual and suspicious insider trading by Marchuk. Marchuk was a senior corporate officer with access to internal information about sales and returns and was responsible for the Company's

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22. There is no disagreement that "general" claims of motive and opportunity are insufficient to allege the requisite state of mind. *See Helwig*, 251 F.3d at 551 ("pleading conclusory labels of motive and opportunity will not suffice."); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 535 (3d Cir. 1999) (rejecting "blanket assertions" and "catch-all allegations" of motive and opportunity); *Greebel*, 194 F.3d at 197.

contacts with analysts and investors. L. 7 (¶ 14). As of December 30, 1996, Marchuk owned 24,250 shares of Scholastic stock. He had sold no such stock since April 11, 1995, some 20 months earlier. L. 37 (¶ 81), but between December 31, 1996 and January 7, 1997, Marchuk sold 80% of his holdings, or 19,400 shares, for proceeds in excess of $1.2 million. *Id.* Moreover, these sales took place shortly after he participated in the conference call with analysts in December during which he assured analysts that sales were not declining, when in fact they were, that continued 20% growth was reasonable, when in fact it was not, and that the Company was "most comfortable" with earnings projections of around $.64 per share, when in fact the Company was being hit by materially lower sales and higher returns. L. 23-26 (¶¶ 50, 52, 81).

As these facts confirm, the allegations against Marchuk were not based solely on motive and opportunity. As one court has recently noted, that would be an unusual situation.

> Appropriate allegations of motive and opportunity may meaningfully enhance the strength of the inference of scienter, but it would seem to be a rare set of circumstances indeed where those allegations alone are both sufficiently persuasive to give rise to a scienter inference of the necessary strength and yet at the same time there is no basis for further allegations also supportive of that inference.

Nathenson v. Zonagen, 2001 U.S. App. LEXIS 20902 at *52 (5th Cir. 2001).[23]

Based on these factual allegations, the Second Circuit held that the Complaint adequately alleged scienter based on a strong inference emanating from Marchuk's significant and unusual insider sales. Pet. App. 19a-22a. The same result would have been reached in any Circuit.

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23. Indeed, the Second Circuit also noted Marchuk's access to internal Company data regarding book sales and returns. Pet. App. 22a.

III. PETITIONERS' ARGUMENT THAT CIRCUIT AND DISTRICT COURTS ARE CONFUSED ON PSLRA ISSUES IS NOT SUPPORTED BY THE CASES OR THE STUDY CITED, AND IS IRRELEVANT TO THIS PETITION

Petitioners devote their final two pages of the Petition to describing asserted confusion among district courts in applying PSLRA standards, citing a few district court cases (decided *before* their circuits issued determinative decisions) and a "work-in-progress" "discussion paper" (*see* website cited by Petitioners) issued by the John M. Olin Center for Law & Economics just a month before the Petition was filed (Joseph A. Grundfest & A.C. Pritchard, "Statutes with Multiple Personality Disorder: The Value of Ambiguity in Statutory Design and Interpretation" (Aug. 23, 2001) ("Multiple Personality").

The paper offers a statistical analysis of circuit and district court decisions on the PSLRA "motive and opportunity" scienter pleading issue, but does not address the other PSLRA issues raised by Petitioners at all. Multiple Personality at 51. Petitioners' descriptions of the results of the study are misleading. Petitioners imply that the paper's analysis of district court decisions on motive and opportunity, supporting a "coin-toss" model of judicial behavior, applies today. Pet. at 27. The paper, however, makes clear that each district court decision studied "*predates* the issuance of [an appellate] decision addressing the strong inference standard by any panel of the Court of Appeals for the circuit in which the district court resides." *Id.* at 61 (emphasis added). In other words, the paper's conclusion about district court behavior is largely historical and *in*applicable today, since most circuit courts have now interpreted the strong inference provision. *Id.* at 47-50. The Petition's suggestion that the paper found that diverse district court interpretations represent a *current* problem is thus *contrary* to what the paper studied.

With respect to the circuit courts, Petitioners emphasize the paper's suggestion that the Second Circuit "motive and opportunity" pleading standards are too lax, noting reversals of the last four complaint dismissals to reach the Second Circuit. As demonstrated above, however, regardless of the labels employed, there is substantial agreement among the circuits as to the type of facts which will support a strong inference of scienter. *See* Point II, *supra*. Moreover, the fact that the Second Circuit reversed (or remanded) four recent dismissals means nothing as those rulings were justified by the allegations at issue and not any lax legal standard. Indeed, the Second Circuit affirmed a dismissal of an inadequate PSLRA pleading in its most recent decision on the issue, *Kalnit v. Eichler*, 2001 U.S. App. LEXIS 19665 (2d Cir. Sept. 5, 2001). There, the Second Circuit found the motive and opportunity allegations of the complaint, which were predicated on generic motives such as the desire to protect existing compensation arrangements and to avoid personal liability, to be inadequate to plead scienter. The Court contrasted the facts in *Kalnit* with its decision in the instant case, where the inference of scienter flowed from unusual insider trading resulting in specific significant and individualized benefits to the defendant. *Id.* at *23-*24. The difference between the two factual scenarios is dramatic as all courts, not just the Second Circuit, have recognized.

CONCLUSION

For the reasons stated herein, Respondents respectfully pray that the Petition for a Writ of Certiorari be denied.

Respectfully submitted,

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APPENDIX

APPENDIX — [CORRECTED] SECOND CONSOLIDATED AMENDED CLASS ACTION COMPLAINT DATED MARCH 8, 1999

[Omitted here but submitted separately as Lodging]